No. 18-457

IN THE

Supreme Court of the United States

THE NORTH CAROLINA DEPARTMENT OF REVENUE,
Petitioner,

v.

THE KIMBERLEY RICE KAESTNER 1992 FAMILY TRUST,
Respondent.

ON WRIT OF CERTIORARI
TO THE SUPREME COURT OF NORTH CAROLINA

BRIEF AMICUS CURIAE FOR THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL IN SUPPORT OF NEITHER PARTY

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STATEMENT OF INTEREST OF AMICUS CURIAE[1]

The American College of Trust & Estate Counsel ("ACTEC") is a nonprofit organization of more than 2,500 trust and estate lawyers and law professors from throughout the United States, Canada, Central and South America, Europe, and Asia. Fellows of ACTEC are skilled and experienced in trust and estate law and are elected by their peers on the basis of their professional reputation, quality of their work, and their substantial pro bono contributions to the practice and the public, including lecturing, writing, teaching, and drafting court rules and legislation. ACTEC is dedicated to enhancing trust and estate law and practice through research, education, technical advice to governments, and, on rare occasions, offering assistance to courts in understanding this area of the law.

Established in Los Angeles in 1949, ACTEC's office is now located in Washington D.C. and is governed by 39 Fellows who serve on its Board of Regents, six of whom are the officers of ACTEC. Much of the work done by ACTEC is performed by committees, including the Amicus Review Committee.

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[1] Counsel for the parties were not in any way involved in authoring this brief. Neither counsel for a party nor a party made a monetary contribution to fund the preparation or submission of this brief. No other monetary contributions were made.

The Amicus Review Committee[2] and the officers of ACTEC voted unanimously to approve ACTEC's filing of an amicus brief in this case.[3]

In this case, we believe we can assist the Court in understanding the history and practice of state fiduciary income taxation as applied to undistributed income of trusts and the complexities of such statutes in the context of the multi-state contacts common in today's mobile society.

SUMMARY OF ARGUMENT

Petitioner frames the question before the Court as "Does the Due Process Clause prohibit states from taxing trusts based on trust beneficiaries' in-state residency?" Respondent frames the question this way: Did the North Carolina Supreme Court correctly apply settled due process

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[2] The Amicus Review Committee consists of Margaret G. Lodise, Sacks, Glazier, Franklin & Lodise LLP, Los Angeles, California (chair), Robert W. Goldman, Goldman Felcoski & Stone, P.A., Naples, Florida; Carlyn S. McCaffrey (Past President of ACTEC), McDermott Will & Emery LLP, New York, New York; Professor Robert H. Sitkoff, Harvard Law School, Cambridge, Massachusetts; Bruce M. Stone (Past President of ACTEC), Goldman Felcoski & Stone, P.A., Coral Gables, Florida; and Gregory N. Barrick, Durham, Jones & Pinegar, Salt Lake City, Utah (State Chair, Utah).

[3] The brief was drafted by an ad hoc committee consisting of David A. Berek, Jonathan G. Blattmachr, Jane G. Ditelberg, Gregory Gadarian, Mitchell M. Gans, Carl L. King, Richard W. Nenno, Raj A. Malviya, and Charles A. Redd.

principles to the unique facts of this case when the State sought to tax the worldwide income of a trust to which it had no connection, based solely on the domicile of a discretionary beneficiary who might never in fact become entitled to receive a distribution from this trust? In order to assist the Court in its consideration of due process under the circumstances of this case, ACTEC's brief discusses the nature of trusts, the income taxation of trustees under federal and state laws, and due process jurisprudence that may have an impact on the income taxation of trustees.

ARGUMENT

I. INTRODUCTION

The goal of ACTEC is to assist the Court in understanding the nature of irrevocable trusts and the relationship between the Due Process Clause and state fiduciary income tax laws.

Our discussion is limited to the income taxation of trustees of trusts that are subject to taxation under the general rules of Subchapter J of Chapter 1 of the Internal Revenue Code of 1986, as amended ("I.R.C.).[4]

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[4] Trusts that are subject to tax under Subchapter J of Chapter 1 of the IRC are defined in Treas. Reg. §301.7701-4 as arrangements created by "will or by inter vivos declaration whereby trustees take title to property for the purpose of protecting it or conserving it for the beneficiaries under the

II. OVERVIEW OF TRUSTS AND FIDUCIARY INCOME TAXATION

A trust is a legal arrangement created by a person (the settlor, grantor, trustor, or testator) who transfers property to another person (the trustee) to hold and administer for the benefit of another person or persons (the beneficiary or beneficiaries). The hallmark characteristic of a common law trust is the division of legal and equitable title to trust assets: "the trustee holds legal title to the trust property, but the beneficiaries have equitable or beneficial ownership." Robert H. Sitkoff & Jesse Dukeminier, WILLS, TRUSTS AND ESTATES, 10th Ed. (2017). This Court recognized this duality and its application in determining the due process implications of state taxation of trusts in *Greenough v. Tax Assessors*, 331 U.S. 486, 494 (1947). *See also Americold Realty Tr. v. Conagra Foods Inc.*, 136 S. Ct. 1012 (2016) (focusing on the citizenship of the trustee, not the beneficiaries, for diversity-of-citizenship purposes after acknowledging that a trust is not a separate entity but a fiduciary relationship). Thus, fiduciary

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ordinary rule applied in chancery or probate courts." Other arrangements that may be referred to as "trusts," such as business trusts, are not subject to the rules of Subchapter J. Instead, they are taxed as associations, corporations, or partnerships. Subchapter J treats the income of certain trusts as owned by the trust's grantor or, in some cases, by its beneficiary. The trustees of those trusts do not pay federal tax on trust income. These trusts are generally referred to as "grantor trusts". Trusts that are not subject to the grantor trust rules are referred to as "nongrantor trusts". Most states, but not all, follow the federal rules and will not subject the trustees of grantor trusts to state income tax.

income tax (the tax imposed on income earned from trust assets but not distributed to and taxed to a beneficiary) is imposed on a trustee, and not on the trust itself, which is not a separate entity or taxpayer. That a trust may be acknowledged as having a separate existence for income tax purposes only, *Anderson v. Wilson*, 289 U.S. 20, 27 (1933) ("[T]he law has seen fit to deal with this abstraction [i.e., a trust] for income tax purposes as a separate existence"), does not diminish the fact that a trust, as such, cannot sue or be sued or take or be impacted by any action. A trust acts and is acted upon only by and through its trustee.

A. State Taxation of Trustees

States that impose a fiduciary income tax generally impose their tax on trustees of trusts that have certain defined connections to the state. Most states refer to these trusts as "resident trusts."[5] States define the relevant connections for a resident trust in several different ways. These differences lead to inconsistent state fiduciary income tax treatment of the same trustees and can result in the same income being subject to state income tax two or more times. Some states, recognizing the constitutional limits on their ability to tax, do not

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[5] Additionally, many states impose a fiduciary income tax on trustees of trusts that do not meet that residence test but have income generated within that state, commonly known as "source income." The taxation by a state of trust income sourced in that state is not the subject of this proceeding.

tax trustees of resident trusts in certain circumstances.[6]

B. Trustee Taxation and Constitutional Limitations

One of the first reported decisions of this Court to test the constitutionality of a state's taxation of trustees was *Safe Deposit & Tr. Co. v. Virginia*, 280 U.S. 83 (1929). The *Safe Deposit* case involved a state intangibles tax assessed by Virginia against a Maryland trustee. The Court held that the imposition of an intangibles tax by Virginia was unconstitutional under the Due Process Clause because the actual situs of the property was in Maryland where the trustee, the holder of legal title to the trust property, was located, and neither the grantor nor the beneficiaries who resided in Virginia had control over the trust estate.

As discussed below, the states that impose fiduciary income taxes have made various choices in selecting the basis for taxation of trustees. While North Carolina has sought to impose a tax based

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[6] New York State, for example, will not tax the trustees of a resident trust if the trust has no trustees who are domiciled in New York, no New York source income, and no physical property located in New York. N.Y. Tax Law §605(B)(3)(D). *See also* Richard Nenno, *Bases of State Income Taxation of Nongrantor Trusts, State Survey*, American College of Trust and Estate Counsel (ACTEC), updated February 25, 2019, https://www.actec.org/assets/1/6/Nenno_state_nongrantor_tax_survey.pdf, *passim*, for a summary of the state fiduciary income tax statues. (Nenno, *State Survey*).

upon the residence of a beneficiary within the state, the legislature could have selected any number of other grounds for taxation which might not have been constitutionally problematic.[7]

C. Shared Beneficial Interests

In addition to the bifurcation of the ownership of trust property between legal and equitable interests (held respectively by the trustee and the beneficiaries), the trust itself can provide a variety of benefits for one or more different beneficiaries. These interests can be consecutive (current and future beneficiaries) or concurrent (multiple current beneficiaries). In addition, beneficiaries can be designated as contingent recipients of an interest in trust property, meaning their right to receive property is not vested, and non-contingent recipients of trust property, meaning the beneficiary has a vested interest in receiving trust property (though such a right can be subject to divestment upon the happening of a contingency, if the terms of the governing instrument so provide).

A trustee may have an obligation to distribute all income earned by trust assets to a particular beneficiary or group of beneficiaries, an obligation to distribute all income but discretion over who among

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[7] Choosing another basis for imposing a fiduciary income tax might not have resulted in tax paid by the trustee of the Kaestner Trust but the state could have generated income tax from trustees of other trusts that did meet the alternate residency test.

the group of permissible beneficiaries receives it, or complete discretion over whether, when and to whom to distribute trust income. A beneficiary's interest in a trust may be contingent upon an exercise of discretion by a trustee, or contingent upon the happening of an event such as reaching a specific age or the beneficiary's survival until the termination of someone else's beneficial interest in the trust. For example, a trust instrument may provide for distributions of income to a beneficiary only in the discretion of the trustee until the beneficiary reaches age 21, and mandatory distribution of all income to the beneficiary after age 21. For purposes of this discussion, we will consider a beneficiary who is entitled by the terms of the trust to receive all or a portion of the income generated by trust assets in a particular year as having a "vested" interest. All other beneficiaries have contingent income interests until the necessary condition has been satisfied and will be referred to as having contingent interests.

A trust may have a single beneficiary who is a current permissible recipient of trust income or to whom income must be distributed. Many trusts have multiple beneficiaries who, at any particular time, are permissible recipients of trust income in the discretion of the trustee. These contingent beneficiaries may be adults or minors, and may live in one state or in many states. Each may be receiving significant distributions from a trust or may never receive any distribution from the trust, depending on the trust terms and the needs and other resources of that beneficiary as well as

anticipated needs of future contingent beneficiaries. Some trusts provide time periods where no distribution may be made to any beneficiary.[8]

D. Contingent Beneficiaries and the Conduit Nature of Fiduciary Income Taxation

It is possible that a contingent beneficiary may never receive a distribution of trust property. A contingent beneficiary possesses no current ownership rights in the trust property, and the property is not vested in the beneficiary.

The federal model of fiduciary income taxation provides that income is taxed only once: either to the beneficiary or to the trustee. In broad terms, income earned from trust assets is generally taxable to the beneficiary if the income is distributed or if the beneficiary has the unrestricted right to demand distribution. The income is otherwise taxable to the trustee. Thus, unless the beneficiary has such an unrestricted right, undistributed income is taxable to the trustee. I.R.C. §§ 651-652 and 661-662.

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[8] For an extreme example, *see* Barry, *Mr. Thullusson's Will*, 22 VA. L. REV. 416 (1935-36), describing Peter Thellusson's Will, which directed at his death in 1797 that all income must be accumulated until all of his sons and grandsons living at his death were deceased, which was a period of about sixty years.

III. STATE APPROACHES TO TAXATION OF TRUSTEES

A. No Income Taxation

Currently, seven states—Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming—do not have a state income tax. Additionally, New Hampshire generally does not tax the income of trustees of nongrantor trusts[9] resident in its state

B. Criteria for Income Taxation of Trustees of Resident Trusts

Each of the other states and the District of Columbia taxes trustees of trusts resident in its jurisdiction. A trust can become a resident trust in one or more particular states under one or more of the following criteria:[10] (1) if the trust was created by the Will of a testator who was domiciled in the state

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[9] Unless otherwise specified, all references to "trust" mean a nongrantor trust, as discussed earlier in this brief at Section I, footnote 4.

[10] A few states also view a statement of governing law in the trust agreement as a factor in determining trust residency. For example, Louisiana taxes a trust if the trust specifically provides that Louisiana law governs, but it does not tax such a trust if the trust specifies that the law of another state applies. *See* Louisiana Fiduciary Income Tax Return and Instructions, form IT-541 at 4. However, Idaho and North Dakota consider the designation of their laws as only one factor in determining whether a trust is a resident trust. *See* Nenno, *State Survey*.

at death; (2) if the settlor of an inter vivos trust was domiciled in the state when the trust became irrevocable; (3) if the trust is administered in the state; (4) if one or more trustees live or do business in the state; or (5) if one or more beneficiaries are resident in the state.

C. The North Carolina Approach

The approach adopted by North Carolina is uncommon. A total of only four states (North Carolina, Tennessee, Georgia, and California) impose a tax on trustees of trusts based on the residence of a beneficiary in the state. In addition, of those four, only two, North Carolina and Tennessee, do so based upon the residence of contingent beneficiaries.[11] The North Carolina Supreme Court held that the North Carolina statute as applied to the trustees of the Kaestner Trust violates the Due Process Clause. There is no published decision in Tennessee on this issue.

Where a trust has sufficient contacts with a state, the state may tax the trustee on undistributed

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[11] *See* Cal. Rev. & Tax. Code §§ 17041(a)(1), 17043(a), 17742(a). In Georgia, this result is reached by analogy to. Ga. Comp. R. & Regs. 560-7-8- .35(1)(d.), which does not characterize a trust with Georgia beneficiaries but a non-resident trustee as a resident trust and does not require such a trustee to withhold tax upon the sale of real estate in such trusts. In Tennessee, the entire income tax is being phased out and will be fully repealed as of January 1, 2021. *See* Tenn. Dept. Revenue, *2018 Guidance for Tennessee's Hall Income Tax Return*, July 12, 2017.

income. The question in this case is whether the trustees of a trust having no contacts with North Carolina other than the residence of its contingent beneficiaries, may be subject to tax in North Carolina on undistributed income that is not sourced within the state and which may or may not ever be distributed to a North Carolina resident. North Carolina's tax regime attempts to tax undistributed trust income which a large majority of the other states do not tax. Of course, North Carolina is free to tax such income as it chooses as long as its tax regime complies with the requirements of the Due Process Clause.

IV. THE SAME TRUST COULD BE A RESIDENT OF SEVERAL STATES OR OF NO STATE

There is no universal rule among the states that a trust is allowed to be a resident of only one particular state. Consequently, depending on the circumstances, a trust could easily satisfy one or more of the residency criteria of multiple states where the settlor, trustee, beneficiary, and assets have a nexus. This overlapping effect creates the problem of trusts that are treated as resident trusts in more than one state and thus the trustees of such trusts are potentially subject to multiple state income tax levies without an offsetting tax credit or other mechanism to allay the impact of double taxation. Although this Court has held that state taxation by multiple jurisdictions is federally constitutional in the transfer tax context, *see, e.g., Curry v. McCanless*, 307 U.S. 357, 368–71 (1939), it

has not addressed state residency-based income taxation by multiple jurisdictions.

In 2015, the Multistate Tax Commission, a United States intergovernmental state tax agency created by the Multistate Tax Compact of 1967, took up an inquiry concerning the problems created by the patchwork of state fiduciary income tax regimes. The Commission made a key observation about a proposed uniform fiduciary income tax statute:

> Due to increasing state interest in attracting financial institutions, the group decided to eliminate any factor from the residency test related to trustees or trust administration. The project therefore would involve determining which remaining factors best reflect a trust's presence in the state; whether multiple factors or a hierarchy would be involved [.]"[12]

In this case, petitioner points to the fact that the Kaestner Trust may avoid state income taxation altogether because it is not a resident trust in any state. While this may be true in a particular year, this is not because there are no states with a nexus sufficient to impose a tax on the trustee of the Kaestner Trust if such a state elected to adopt a

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[12] Lila Disque, *Interstate Taxation of Trusts: The Multistate Tax Commission Project.*, address and materials in connection with the American Bar Association Section of Real Property, Trust and Estate Law Spring Symposia, State Income Taxation of Trusts Holding Business Interests (Apr. 30, 2015) (project ultimately abandoned when states could not reach consensus concerning approach to taxation).

different tax regime. Further, if the income accumulated and not subject to North Carolina tax in one year is distributed to a North Carolina resident in a later year, North Carolina could, as outlined below, impose its tax then when it has become clear that the resident beneficiary has in fact received previously accumulated income.

States typically impose tax on a beneficiary in the year in which the beneficiary receives the income from the trust. The mechanism for this taxation involves granting the trust a deduction for the payment and requiring the beneficiary to include the income in his or her tax return in the same year. In this case, because no distribution was made to the beneficiary, this mechanism did not apply. As a result, North Carolina would not ever be able to tax the accumulated income when it was distributed unless it changed its statute to tax the distribution of accumulated income in the year of receipt by a beneficiary.

North Carolina has chosen not to use this approach. Instead, North Carolina attempts to impose an income tax directly on the trustee in the year in which the income is earned on the sole basis that the trust's contingent beneficiary resided in North Carolina. The facts in this case demonstrate why this approach may not satisfy the minimum connection requirement of the Due Process Clause. No distributions were ever made to Ms. Kaestner while she was a resident of North Carolina, and indeed might never be made to a person who resided in North Carolina at the time of a distribution. If

income is accumulated in the discretion of the trustee while Ms. Kaestner lives in North Carolina but is never distributed to her and is ultimately distributed to a resident of another state in a future year, North Carolina's only connection with that income will have been the possibility that it might have been, but was not, distributed to a North Carolina resident.

Petitioner argues that "[b]eneficiaries[13] like Ms. Kaestner can now accumulate income in their trusts over several decades, avoid taxes on that income, and then, before taking a distribution from their trusts, simply move—even temporarily—to a state like Florida that does not assess income taxes. Nothing would stop these beneficiaries from returning the following year to their home state to resume residency after taking tax-free distributions from their trusts." Petition for Writ of Certiorari dated October 9, 2018 at 21. We note that the same problem arises if residents of North Carolina purchase publicly traded stock that appreciates while the owners reside in North Carolina but who, before selling the stock, simply move to Florida.

Other states have sought to address this problem, in part, through the imposition of a tax on the distribution of a trust's accumulated income.

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[13] It is a trustee, and not a beneficiary, that makes decisions about distributing or accumulating income. We assume petitioner is using this term as short-hand for a beneficiary not requesting a distribution or objecting to the accumulation of income by the trustee.

This type of tax is commonly referred to as a "throwback tax." In some cases, federal income tax law imposes a tax on the distribution of accumulated income in order to prevent the tax savings that could result from temporary accumulations of income of a trust that paid income taxes at lower rates than its beneficiaries and the tax savings that could result for the beneficiaries of foreign trusts that pay no federal tax on accumulated income. I.R.C. §§665-668. The tax is computed essentially by "throwing" the accumulated income back to the tax years of the beneficiary that roughly correspond to the years when the income was earned by the trust. The beneficiary receives a credit for the federal income tax paid by the trustee in those years. Although the throwback tax formerly applied to both foreign and domestic trusts, because the income tax rates for trustees have been sufficiently compressed to eliminate the opportunities for this type of perceived abuse in the case of domestic trusts, the throwback rules have been limited in application generally only to foreign trusts and domestic trusts that used to be foreign. *See, generally*, General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514), prepared by the Staff of the Joint Committee on Taxation (May 4, 1987), 1243-1246

Any state could adopt similar throwback rules. Pennsylvania,[14] California,[15] and New York have done so.[16] Under such a throwback regime, the beneficiary who actually receives and benefits from the accumulated income would be taxed on it. For example, if a trustee accumulates income in 2019 while a contingent beneficiary lives in California, California does not tax it in that year. However, if a distribution is made to the California beneficiary in 2020 that includes income accumulated in 2019, California imposes its tax in 2020.[17]

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[14] Pennsylvania assesses a throwback tax on accumulation distributions to resident beneficiaries from nonresident trusts. 61 Pa. Code § 105.5(c).

[15] The California throwback rule provides that a beneficiary who currently receives income that was not previously taxed in California because the beneficiary had a contingent interest at the time it was accumulated is subject to tax on the distribution when it is distributed to him or her. CA. Rev. & Tax Code § 17745(b) provides that "if no taxes have been paid on the current or accumulated income of the trust because the resident beneficiary's interest in the trust was contingent, such income shall be taxable to the beneficiary when distributed or distributable to him or her."

[16] The New York throwback rule was enacted to address situations involving nongrantor trusts which qualify for an exception from New York income tax applicable to certain New York resident trusts and that accumulate income which is distributed to New York resident beneficiaries in subsequent years. N.Y. Tax Law § 612(b)(40).

[17] California Franchise Tax Board, Form 541, Schedule J.

The federal throwback rules generally require the recipient of a distribution of accumulated trust income to be taxed essentially as if that income had been received when it was earned by the trust. Adjustments for the time value of money, that is to say interest on the tax deferred until the accumulated income is distributed, can eliminate the financial advantages to the beneficiary of the deferral of the tax. *See* I.R.C. §668 (imposing a non-deductible interest charge on the throwback tax imposed on accumulated distributions from foreign trusts).

The fact that a beneficiary who anticipates receiving accumulated income might escape state taxation of this income by changing his or her state of residence before the receipt of the accumulated income, creates no different a problem than the possibility that individual taxpayers may avoid state taxation by changing residency before any other type of income is received. For example, a shareholder who anticipates receiving a substantial dividend next year on stock he or she currently owns can change residency before the dividend is received by moving to a state with no (or a lower) income tax on dividends. The result should be no different for trust distributions of accumulated trust income.

Moreover, the hypothetical posited by petitioner – a North Carolina resident beneficiary moves to another state to receive the distribution and then moves back to North Carolina – is easily addressed through the application of conventional anti-abuse tax doctrines. For example, the move to

the other state could be ignored for tax purposes on the ground it is not a bona fide change in residence.

V. CONSTITUTIONAL CHALLENGES TO STATE INCOME TAXATION OF TRUSTEES

As noted above, the states and the District of Columbia apply one or more criteria to determine whether a trust is a resident trust. If a trust is a resident trust, the state's tax regime generally subjects the trustee of the trust to tax in that state on its worldwide income, regardless of where the income is derived. While it may be obvious in some situations whether a particular state's residency statute applies because of the location of a trustee or sufficient trust administration contacts within the state, other situations may be more challenging to analyze because the state connections have evaporated, shifted, are weak, or are even nonexistent.

In the situations where valid contacts within a state exist, the state may tax the trustee of a trust only if doing so will not violate the state's Constitution and the U.S. Constitution. The rulings of this Court and the decisions of various state and federal courts on the state income taxation of trustees or the application of other state tax statutes have focused on two constitutional restraints on a state's right to impose a tax—the Due Process Clause of the Fourteenth Amendment and the

Commerce Clause. U.S. Const. Amend. XIV, § 1 and U.S. Const. Art. I, § 8, Cl. 3.[18] Given the issues posed in this case, we limit our discussion to the application of due process principles to the taxation of trustees on their undistributed income.

A. Due Process Clause

The Fourteenth Amendment to the U.S. Constitution provides that no state shall "deprive any person of life, liberty, or property, without due process of law." U.S. Const. Amend XIV, § 1. The North Carolina Constitution guarantees due process rights by providing that no person shall be "in any manner deprived of his life, liberty, or property, but by the law of the land." Article I, Section 19 of the Constitution of North Carolina. The North Carolina

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[18] The Commerce Clause gives Congress the sole power to regulate commerce among the states. U.S. Const. Art. 1, §8, cl. 3. In *Kaestner*, the North Carolina Supreme Court only examined the Due Process Clause argument. The court below did not reach the more rigorous Commerce Clause analysis, because it was able to strike down the North Carolina fiduciary income tax statute under the Due Process Clause. As a result, this issue was abandoned by respondent on appeal. In *Complete Auto Transit v. Brady*, this Court articulated a four-part test to determine if a state tax violates the Commerce Clause: (1) Nexus: there must be a sufficient connection between the taxpayer and the state to warrant the imposition of state tax authority; (2) Fairly Apportioned: the state must not tax more than its fair share of the income of a taxpayer; (3) Non-Discrimination: the state must not treat out-of-state taxpayers differently from in-state taxpayers; and (4) Fairly Related to Services: the tax must be fairly related to services the state provides to its taxpayers. *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977).

Supreme Court has noted that "[t]he term 'law of the land' as used in Article I, Section 19, of the Constitution of North Carolina, is synonymous with 'due process of law' as used in the Fourteenth Amendment to the Federal Constitution." *Rhyne v. K-Mart Corp.*, 358 N.C. 160, 180 (2004). Accordingly, the *Kaestner* Court analyzed the State and Federal due process challenges together.

This Court's decision in *Quill Corp. v. North Dakota* is consistently cited in Due Process Clause challenges to state tax statutes. *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992), overruled in part by *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2099 (2018).

According to *Quill*, when a state seeks to impose a tax, the Due Process Clause requires: (1) "some definite link, some minimum connection, between a state and a person, property or transaction it seeks to tax;" and (2) "that the income attributed to the State for tax purposes . . . be rationally related to values connected with the taxing state." *Id.* When analyzing the first requirement, courts consider whether a taxpayer's "connections with a State are substantial enough to legitimize the State's exercise of power over" it. *Id.* at 312. It is important that, when the taxpayer has no physical presence in a state, the taxpayer must "purposefully avail itself of the benefits of an economic market in the forum state." *Id.* at 307. This requirement ensures that the taxpayer is given "fair warning that its activity may subject it to the jurisdiction of a foreign sovereign." *Id.* at 308. The

courts then analyze the second component and assess "whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state." *Id.*

The *Kaestner* Court carefully analyzed the first component of the Due Process Clause under the *Quill* lens."[19] In *Quill*, this Court held that the Due Process Clause's "minimum contacts" test no longer required physical presence in a state to permit state taxation. *Quill Corp.*, 504 U.S. at 318–19. Shortly before this Court's decision in *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2099 (2018), the *Kaestner* Court applied the *Quill* analysis of due process principles and still found that the trustee of the Kaestner Trust did not have the minimum contacts with North Carolina necessary to cause the trustee to be subject to tax.

B. Post *Quill* Decisions Addressing Due Process

Since *Quill* was decided, a handful of state courts have issued published decisions on the constitutionality of state taxation of trustees. Only

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[19] It also applied recent precedent in North Carolina standing for the proposition that "a finding of minimum contacts to satisfy due process will vary with the quality and nature of the [party's] activity, but it is essential in each case that there be some act by which the [party] purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws. *Skinner v. Preferred Credit*, 361 N.C. 114, 123; 638 S.E.2d 203, 210-11 (2006).

two of those decisions, *Dist. of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. App.. 1997) and *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999), upheld the state taxation regime in question on due process grounds. However, in both of those outlier cases, all but one of the trusts at issue were testamentary trusts created under the Will of a resident decedent, thus involving the necessity of the state's probate laws to effectuate the trust. One of the trusts involved in the Connecticut case was an inter vivos trust with one current beneficiary who had significant rights over the trust including the right to receive all trust property at age 45 and the right to direct how the property would be disposed of if she had died before age 45. It is not clear that the court would have reached the same conclusion if the beneficiary's rights were less substantial.

The majority of the decisions, including *Kaestner*, struck down the challenged tax statute as unconstitutional, with the exception of one decision, in which the court held in favor of the taxpayer based on other grounds. *Residuary Tr. A U/W/O Kassner v. Dir. Div. of Taxation*, 28 N.J. Tax 541 (Super. Ct. App. Div. 2015), *aff'g*, 27 N.J. Tax 68 (N.J. Tax Ct. 2013); *Linn v. Dep't of Revenue*, 2 N.E.3d 1203 (Ill. App. Ct. 2013); *McNeil v. Pennsylvania*, 67 A.3d 185 (Pa. Comlth. Ct. 2013); *Kimberley Rice Kaestner 1992 Family Tr. v. N.C. Dep't of Revenue*, 814 S.E.2d 43 (N.C. 2018), *aff'g*, 789 S.E.2d 645 (N.C. Ct. App. 2016), *aff'g*, No. 12 CVS 8740, 2015 WL 1880607 (N.C. Sup. Ct. Apr. 23, 2015); *Fielding v. Comm'r of Revenue*, 916 N.W.2d 323 (Minn. 2018),); *Bank of America, N.A. v. Comm'r*

of Revenue, 54 N.E. 3d 13 (Mass. 2016).

C. *Wayfair*

Only weeks after the *Kaestner* decision, this Court issued its opinion in *Wayfair*, overturning in part its ruling in *Quill*, which had stood as precedent since 1992. In a 5-4 decision, this Court declared that the physical presence requirement of the Commerce Clause, established under the substantial presence prong of the *Complete Auto* Test. was "unsound and incorrect," and that *Quill* and its 1967 predecessor decision, *National Bellas Hess Inc. v. Illinois*, were overruled.

The *Wayfair* decision should have no impact on the *Kaestner* decision. The *Wayfair* decision's rejection of the physical presence test applied to the Commerce Clause, not the Due Process Clause. The *Kaestner* Court, which based its decision on the Due Process Clause, did not rely on the lack of physical presence of the trust or of the trustee in North Carolina because the physical presence test as applied to the Due Process Clause had already been rejected by this Court in the *Quill* case. Although *Quill* rejected the Due Process physical presence test, it still required "'some definite link, some minimum connection, between a state and the person, property or transaction is seeks to tax,' *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-345 (1945), and that the 'income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State." *Moorman Mfg. Co. v. Blair*, 437 U.S. 267, 273 (1978)" *Quill Corp.*, 504

U.S. at 306. The *Kaestner* Court held that the residency of the beneficiary was insufficient to establish the required minimum connection.

A trust is not a business entity, but, as discussed in Section I, is a relationship between a trustee and beneficiaries involving the legal and beneficial ownership of property. Thus, it is difficult to determine where, if anywhere, a trust can be said to have the minimum connection Due Process requires, although, clearly, the residence of the trustees, the beneficiaries, the settlor/testator, or the location of trust assets are all possibilities. The *Kaestner* Court focused on the independent significance of a trust and rationalized how a third party's (a beneficiary's) physical contacts within the state cannot be attributed to the taxpayer (the trustee of the trust) to determine tax residency.

A trustee holds legal title to trust assets. A contingent or discretionary beneficiary generally has no property rights whatsoever until the contingency terminates or trust assets are distributed to him or her. In *Brooke v. City of Norfolk*, this Court considered whether the City of Norfolk and Commonwealth of Virginia had violated the Due Process Clause by taxing the trustee of a Maryland trust when none of the property held in the trust had ever been present in Virginia. Although this Court applied a presence-focused due process analysis that has since been supplanted, this Court also did not attribute the residency of the beneficiary to the trustee, and observed that the property held by the Maryland trustee "was not within the State, does not

belong to the [beneficiary] and is not within her possession or control. The assessment is a bare proposition to make the [beneficiary] pay upon an interest to which she is a stranger," *Brooke*, 277 U.S. at 29. Similarly, in *Mercantile-Safe Deposit & Tr. Co. v. Murphy*, the New York Court of Appeals held that the Due Process Clause prohibited New York from taxing the accumulated income of an inter vivos trust, funded in part during life and in part by a pour-over of assets under the decedent's Will, that had no New York trustee, New York assets, or New York source income, even though the current discretionary beneficiary was a New York resident. *Mercantile-Safe Deposit & Tr. Co. v. Murphy*, 203 N.E.2d 490 (N.Y. 1964), aff'g, 242 N.Y.S.2d 26 (App. Div. 1963).

The parties affected in *Wayfair* were contracting parties each consenting to a sales transaction. This type of contractual relationship is very different from one of a trustee and beneficiary, where the beneficiaries of a discretionary trust normally have no say or control over distributions made by the trustee or the decisions of the trustee regarding the location of trust assets or the trustee's domicile.[20]

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[20] *See In re: Naarden Trust*, 990 P.2d 1085 (Ariz. 1999) (a trust is not a contract); RESTATEMENT (SECOND) OF TRUSTS, Section 169 comment c ("Although the trustee by accepting the office of trustee subjects himself to the duties of administration, his duties are not contractual in nature").

D. The Most Recent Trust Nexus Case: *Fielding v. Commissioner of Revenue*

Less than a month after the *Wayfair* decision, the Minnesota Supreme Court in *Fielding v. Commissioner of Revenue* held that the trustees of four trusts created by a Minnesota domiciliary with a current Minnesota beneficiary, but administered by a non-resident trustee, lacked minimum contacts and could not be subject to state income tax under the Due Process Clause. The court concluded:

> [E]ven when the additional contacts the Commissioner cites are considered in combination, the State lacks sufficient contacts with the Trusts to support taxation of the Trusts' entire income as residents consistent with due process. The State cannot fairly ask the Trusts to pay taxes as resident in return for the existence of Minnesota law and the physical storage of trust documents in Minnesota. Attributing all income, regardless of source, to Minnesota for tax purposes would not bear a rational relationship with the limited benefits received by the Trusts from Minnesota during the tax year at issue. We therefore hold that Minn. Stat. § 290.01, subd.7b (a)(2), is unconstitutional as applied to the Trusts.

Fielding v. Commissioner of Revenue, 916 N.W.2d 323 (Minn. 2018), *aff'g*, 2017 WL 2484593 (Minn. Tax Ct. May 31, 2017), petition to the U.S. Supreme Court for writ of

certiorari filed Nov.15, 2018.

Fielding found the application of the Minnesota tax regime violated the Due Process Clause.[21] Because of this, the *Fielding* Court did not need to address Commerce Clause arguments. *Fielding*, 916 N.W.2d at 334 n.11.

VI. WITHOUT MINIMUM CONTACTS THERE IS NO JURISDICTION OVER THE TRUSTEE

A critical component of the due process analysis involves an evaluation of personal or *in rem* jurisdiction. The Due Process Clause does not permit a state to exercise personal jurisdiction over an individual or corporation with which the state has no contacts, ties, or relations. *International Shoe Co. v. Washington*, 326 U.S. 310 (1945).

In considering whether a particular state has jurisdiction to tax, it is important to remember that a trust is a relationship, not an entity. The trust does not pay tax; the trustee does, and it should not be assumed that a state has jurisdiction to tax a nonresident trustee. This Court articulated this very concept in 2016:

> Traditionally, a trust was not considered a distinct legal entity, but a "fiduciary

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[21] On November 15, 2018, the Minnesota Department of Revenue filed a petition for certiorari with this Court.

> relationship" between multiple people. Such a relationship was not a thing that could be haled into court; legal proceedings involving a trust were brought by or against the trustees in their own name. And when a trustee files a lawsuit or is sued in her own name, her citizenship is all that matters for diversity purposes. For a traditional trust, therefore, there is no need to determine its membership, as would be true if the trust, as an entity, were sued.
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> *Americold Realty Tr. v. Conagra Foods, Inc.*, 136 S. Ct. 1012, 1016 (2016) (citations omitted). *See also Raymond Loubier Irrevocable Tr. v. Loubier*, 858 F.3d 719, 722 (2d Cir. 2017) ("[I]t is the trustees' citizenship, not that of beneficiaries, that matters for purposes of diversity"); *Yueh-Lan Wang v. New Mighty U.S. Tr.*, 843 F.3d 487, 487 (D.C. Cir. 2016) ("a so-called 'traditional trust' carries the citizenship of its trustees").

This Court addressed the limits of personal jurisdiction in 2017, in *Bristol-Myers Squibb Co. v. Superior Court of California*. There, Justice Alito described the limits on the California courts' exercise of personal jurisdiction:

> It has long been established that the Fourteenth Amendment limits the personal jurisdiction of state courts. Because a state court's assertion of jurisdiction exposes defendants to the State's coercive power, it is

subject to review for compatibility with the Fourteenth Amendment's Due Process Clause, which limits the power of a state court to render a valid personal judgment against a nonresident defendant. The primary focus of our personal jurisdiction inquiry is the defendant's relationship to the forum State.

* * *

Since our seminal decision in International Shoe, our decisions have recognized two types of personal jurisdiction: "general" (sometimes called "all-purpose") jurisdiction and "specific" (sometimes called "case-linked") jurisdiction. For an individual, the paradigm forum for the exercise of general jurisdiction is the individual's domicile; for a corporation, it is an equivalent place, one in which the corporation is fairly regarded as at home. A court with general jurisdiction may hear any claim against that defendant, even if all the incidents underlying the claim occurred in a different State. But only a limited set of affiliations with a forum will render a defendant amenable to general jurisdiction in that State.

Specific jurisdiction is very different. In order for a state court to exercise specific jurisdiction, the suit must arise out of or relate to the defendant's contacts with the forum. In other words, there must be an affiliation between the forum and the

> underlying controversy, principally, an activity or an occurrence that takes place in the forum State and is therefore subject to the State's regulation. For this reason, specific jurisdiction is confined to adjudication of issues deriving from, or connected with, the very controversy that establishes jurisdiction. *Bristol-Myers Squibb Co. v. Superior Ct. of California*, 137 S. Ct. 1773, 1779, 1780-81 (2017).

This Court concluded that the connection between the nonresident's claims and the forum was too weak and thus, the California courts lacked specific personal jurisdiction. *Bristol-Myers*, 137 S. Ct. at 1782.

The 2013 decision of a federal district court in Pennsylvania in *Bernstein v. Stiller* dealt with a comparable issue. There, trust beneficiaries sought accountings and removal of the trustees in Pennsylvania and contended that the trustees' filing of a state income-tax return declaring the trust to be a Resident Trust gave the court jurisdiction. Judge Surrick held:

> The declared residency of the trust assets is insufficient to give the Court personal jurisdiction over Respondent Trustees.

Bernstein v. Stiller, 2013 WL 3305219, at *1 and 7 (E.D. Pa. June 27, 2013).

A court will have personal jurisdiction over a foreign trustee in certain situations, such as when it appointed the trustee. *See Ohlheiser v. Shepherd*, 228 N.E.2d 210, 215 (Ill. App. Ct. 1967). *Ohlheiser v. Shepherd* involved a Wisconsin resident who was appointed as successor trustee of an Illinois testamentary trust. There the trustee argued "a nonresident defendant must have certain minimum contacts with the forum state before jurisdiction in personam can be obtained by service of process outside the state." The court disagreed, stating "we consider that defendant, as successor trustee of a testamentary trust, became an officer of the court appointing him when he accepted the appointment by entering upon his duties as successor trustee. Although these duties did not require him to perform any act while physically within the State of Illinois, he impliedly submitted himself to the in personam jurisdiction of the court of appointment until discharged from his office."

VII. APPLYING THESE PRINCIPLES TO STATE FIDUCIARY INCOME TAX CASES

In *Quill,* the Court indicated that, under the Due Process Clause, a state may only impose a tax if "some minimum connection" or "definite link" exists between the state and the "person, property or transaction it seeks to tax." *Id.* at 306 (quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344–345 (1954)). The *Quill* Court, in determining the due process requirements applicable in assessing the validity of a state tax, went on to apply the personal-jurisdiction contours it has deduced from

International Shoe Co.: an inquiry that focuses on whether the "defendant had minimum contacts with the jurisdiction." 504 U.S. at 307-8.

In *Hanson v. Denckla*, 357 U.S. 235, 253–254 (1958), the Court concluded that Florida courts did not have personal jurisdiction over a Delaware trustee of a trust even though its beneficiaries resided in Florida. *Id.* at 254 (it would be a nonsequitur to conclude that the Florida courts "should be able to exercise personal jurisdiction over the nonresident trustees" on the ground that "most of the appointees and beneficiaries were domiciled in Florida"). The Court has repeatedly reaffirmed *Hanson*. *See, e.g., Bristol-Myers Squibb*; *Walden v. Fiore*, 571 U.S. 277, 284 (2014).

To the extent that due process limitations on personal jurisdiction and taxation are to remain consistent, a decision that expands the scope of a state's taxing power should concomitantly expand the jurisdictional reach of courts over out-of-state defendants. Thus, should the Court decide that due process permits a state in which beneficiaries reside to tax a trust being administered by a trustee in another state based solely on the fact of the beneficiary's residence, it should reconsider *Hanson*. Likewise, should the Court decide to adhere to the principle adopted in *Hanson* – that a state in which the beneficiary resides does not have personal jurisdiction over an out-of-state trustee – it should reject the petitioner's argument that the presence of beneficiaries in North Carolina permits it to tax the undistributed income of out-of-state trustees.

Petitioner argues that *Safe Deposit & Trust Co.* – holding that due process does not permit the state of the beneficiary's residence to tax the income of a trust being administered by an out-of-state trustee – should be overruled. Indeed, if it is not overruled, the petitioner's argument is foreclosed. To be sure, *Safe Deposit* does predate *International Shoe* and, to the extent of any inconsistency, it should be reconsidered. But *Safe Deposit* does not appear to be inconsistent with the *International Shoe* framework. In *Hanson*, applying the framework, the Court concluded that the residency of the beneficiary was an insufficient contact for jurisdictional purposes, thus suggesting that *Safe Deposit's* analogous conclusion in the tax context is not only consistent with the framework but compelled by it. In short, should the Court decide to reconsider *Safe Deposit*, a similar reexamination of *Hanson* would be in order.[22]

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[22] Another line of authority implicated by a decision to make the beneficiary's residence determinative relates to the application of diversity-of-citizenship jurisdiction in the context of trusts. The Court has held that, where a trust is a party, the citizenship of the trustee, not the beneficiary, is controlling for diversity purposes – treating the trust as a relationship between trustee and beneficiary and not as a separate entity. *Americold Realty Tr. v. Conagra Foods, Inc.*, 136 S.Ct. 1012 (2016) (traditionally, trust "not considered a distinct legal entity, but rather a 'fiduciary relationship' between multiple people"). If the Court adheres to this concept of a trust as a relationship, it would seem that the contacts of a beneficiary with a state should not be imputed to the trust – no more than the contacts of one contracting party should be imputed to other contracting parties. Thus, should the Court decide to

Taxing the trustee based on the contacts of the beneficiary with the taxing state appears to be at odds with the thrust of the *International Shoe* framework. The inquiry under the framework is whether the taxed party (or the transaction) or the defendant in the jurisdictional context has the requisite contact with the state asserting its taxing power or its jurisdiction. Imputing the contacts of the beneficiary to the trustee would entail a different inquiry. Thus, should the Court decide to adopt a principle that imputes the beneficiary's contacts to the trustee, it may want to explicitly adjust the focus of the *International Shoe* framework. Further, an analysis that seeks to tax the trustee based on the beneficiary's residence should take into account the speculative nature of the connection between the trust's income and its beneficiary. As suggested, in the overwhelming majority of cases, the beneficiary does not have a vested right to the trust's accumulated income and may indeed never become entitled to receive it – thus raising the question whether it is appropriate to make relevant the residence of such a beneficiary. *See Brooke v. City of Norfolk* at 28 (impermissible to make the beneficiary pay tax on property "not within her possession or control").

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impute the contacts of the beneficiary to the trustee for purposes of state taxation, it may want to reconsider the treatment of trusts for diversity purposes.

CONCLUSION

The American College of Trust and Estate Counsel is grateful for the opportunity to bring these issues to the attention of the Court.

Respectfully submitted,

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